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Alternative (Low Tax) Budget for 2005

Georgi Angelov

1. Summary

For the second time the Institute for Market Economics prepared an alternative government budget. In the 2005 alternative budget we envisage revenues totaling 34.5% of GDP (39% in the government draft) and expenditures amounting to 32.8% of GDP (39.3% in the government draft). The main reforms supporting the budget are:

- **10% flat rate for all direct taxes** – corporate tax, income tax, social security tax
- **Public expenditure cuts** – through decrease of public sector staff, optimization of the maintenance expenditures, decrease of the subsidies for loss-making activities, reducing the inefficient meddling in the labor market, transfer of activities to the private sector and faster privatization.
- **Using the budget surpluses** for pension reform (privatization of the pension system), capitalization of the social security and other structural reforms.

As a result of the 10% flat tax rate:

- The taxation of the companies and individuals will be cut by half
- The incentives for work, entrepreneurship, risk-taking, saving and investment will increase
- The distortions, caused by the taxation will decrease (deadweight loss)

- The economic development will be faster and the wealth will increase
- The incentives for tax avoidance and tax evasion will diminish as well as the gray economy
- The net incomes of the taxpayers will increase by 30-40%

In addition to that, we propose a 3-year budget reform, including additional reforms for 2006 and 2007:

- Zero corporate tax
- Private competitive health funds and hospitals, pension reform, voucher system in the education
- Program budgeting, continuing reduction of the public service staff and the subsidies

The proposed reforms will ensure a stable double-digit economic growth and corresponding rapid increase of the incomes of Bulgarian citizens. In addition, the reforms will increase the efficiency of the public spending and the quality of the public services, healthcare and education.

2. Alternative budget: taxes and revenues

Tax Reform

The main goal of the alternative budget for 2005 is to show that it is possible to achieve a considerable reduction of the direct taxes and at the same time to maintain a balanced budget or even budget surplus. We propose the following reforms in the tax system:

- Decrease of the corporate tax to 10% (19.5% in 2004)
- Decrease of the income tax to 10% (12-29% in 2004)
- Decrease of the social security tax to 10% (42.7% in 2004)
- Abolition of the dividend tax (15% in 2004)

Revenues in the consolidated budget

The total revenues in the alternative budget, prepared by the Institute for Market Economics, are 14.4 billion leva¹ or 34.5% of GDP (see table 1 below). The revenues in the budget prepared

by the government are about 16 billion leva, i.e. 39% of GDP. These revenues, however, are underestimated by about 1 billion leva, therefore we assume that expected revenues are about 17 billion leva, i.e. more than 41% of GDP (like in 2004). Therefore the alternative budget seizes 6.5% of GDP less resources from the economy than the budget of the government.

¹ Under the currency board regime the exchange rate of the leva is fixed to the euro at 1.96 leva per 1 euro.

Table 1: Revenues in the alternative government budget, prepared by IME

	Government (budget draft)		Institute for Market Economics	
	mln.levs	% of GDP	mln.levs	% of GDP
Total Revenues	16 067.0	38.9	14 436.2	34.5
1. Tax Revenues	13 093.9	31.7	11 272.2	26.9
<i>Direct taxes</i>	6 412.4	15.5	3 798.3	9.1
Corporate taxes	981.6	2.4	917.4	2.2
Income tax	1 216.6	2.9	1 259.8	3.0
Social security tax	4 214.2	10.2	1 621.1	3.9
<i>Indirect taxes</i>	6 341.9	15.3	7 105.0	17.0
VAT	4 185.0	10.1	4 426.9	10.6
Excises	1 916.8	4.6	2 344.1	5.6
Customs duties	240.1	0.6	334.0	0.8
<i>Other taxes</i>	341.6	0.8	369.0	0.9
2. Non-tax revenues	2 451.0	5.9	2 643.8	6.3
3. Aid	520.1	1.3	520.1	1.2

Note: The differences between the budget, prepared by IME and the budget, prepared by the Government are due to the tax reforms proposed by IME and the fact that the revenues in the government budget for 2005 are underestimated.

A. Taxation of labor

As a result of the proposed tax cuts we expect several effects on the revenues from taxation of labor:

- Lower incentives for hiding of incomes – a great part of the labor incomes are misreported because of the high rates of social security and income taxes. When the rates are lower, the incentives for misreporting are also lower and the tax base is increasing.
- Increase of incomes – because of the economic growth and the additional

economic activity and employment because of the lower taxes.

- Increase of the companies' profits – the social security burden is shared between the employer and employee (according to the elasticity of supply and demand of labor). We expect 30% of the social security tax cuts to go to the employer.

The total effect of the above-mentioned effects is about 15% increase of the declared labor costs in 2005 as compared with 2004. Therefore the labor costs of employers are to reach about 16 billion leva.

Table 2: Taxation of labor under 10% income and social security taxes

2005	Levs
Employers' labor costs	16 210 829 483
Social security tax	1 621 082 948
Income after social security tax	14 589 746 534
Non-taxable income (personal allowance)	3 354 000 000
Taxable income	11 235 746 534
Income tax	1 259 774 653
Net income after taxes	13 329 971 881

B. Taxation of profits

The 10% corporate tax rate will have the following effects on the government revenues:

- Social security effect – as mentioned, we expect 30% of the reduced social security taxation to go to the employers thus increasing their taxable profits.
- Grey economy effect – corporate taxation is one of the most avoided (and evaded) taxes. The lower tax rates will diminish the incentives for tax avoidance and tax evasion.
- Increase activity effect – lower taxes increase the economic activity and thus the tax base.

As a result of these effects and because a part of the corporate taxes are paid for previous-year profits we expect a relatively small drop in the corporate tax revenues – about 10% drop. So the forecast for revenues from the corporate taxes is 917 million levs.

C. Revenues from excises

The lower taxes lead to higher (net) take-home pay so Bulgarian citizens will be able to consume more goods, including goods that are taxed with excises. In addition, the higher economic activity needs more transportation, i.e. more fuels – taxed with excises. We expect this effect to amount to about 10% increase in the excise revenues.

D. Revenues from Value-added tax (VAT)

As far as the excises are a part of the taxable base for VAT, the additional excises lead to additional revenues from VAT. We expect 1% more revenues from VAT.

E. Non-tax revenues

They can be increased by privatization and public-private partnership. We expect 100

million or 4% increase of these revenues as a result of these actions.

3. Alternative budget: expenditures

Total expenditures and budget balance

The alternative budget has revenues of 13.8 billion levs, i.e. less than 33% of GDP. The expenditures of the government budget are expected to reach about 40-41% of GDP in 2004 so the alternative budget ensures a 7% cut in the expenditures as a share of GDP.

We envisage a budget surplus of 730 million levs. This money is to be used to cover unexpected changes in the economic environment and realization of pension reform (capitalization of the pension system) and/or redemption of government debt (thus decreasing the interest payments of the budget).

Government expenditures reform

A. Salaries and social security taxes (for government employees)

We propose at least a 3% cut of the number of public sector employees. Thus the personnel expenditures will decrease. On the other hand, the decrease of the social security and income taxes will increase the net wage of the public employees and at the same time it will decrease the expenditures of the budget (we divide the income and social security tax cut between the employees and the budget at 50:50 proportion). The institutions that decrease the staff by more than 3% can ensure additional increase of the salaries of their employees.

B. Maintenance

The decrease of the public sector staff combined with the sell of inefficient and unnecessary assets (buildings, cars, land, forests), an increased control over the expenditures and increased efficiency of the expenditures allows the expenditures to be frozen at the 2004 level.

C. Defense and security

The defense expenditures in Bulgaria are at a very high level as a share of GDP compared to most of European countries. Also, the army has lots of assets that are not needed and can be sold – the money obtained in this way can be used for financing part of the capital expenditures of the army. That allows for a 100 million levs reduction of the budget. Again, the decrease of the social security and income taxes will

increase the net wage of the public employees and at the same time it will decrease the expenditures of the budget by about 300 million levs (we divide the income and social security tax cut between the employees and the budget at 50:50 proportion).

D. Subsidies, credits and temporary financial aid

The subsidies for loss-making companies and activities distort the market and hold resources in loss-making activities and thus impede the economic growth. We propose a 50% cut in the subsidies through reform and privatization of the state railways company, faster reform in the coal industry, increase of the efficiency of the state-owned media, continuation of the healthcare reform, privatization of the hospitals etc. In addition, the Agriculture fund needs to start working on market principles and must be privatized eventually.

E. Social expenditures

In this article are included pensions, healthcare, social benefits, compensations etc. We propose elimination of the inefficient programs for meddling in the labor market that cost more than 200 million levs.

F. Capital expenditures

Using privatization and/or public-private partnership for transferring infrastructure to the private sector and more competitive public procurement procedures will lead to a better quality of infrastructure and, at the same, time lower budget expenditures.

G. Reserve for unexpected and urgent expenditures

This article includes funds for natural calamities as well as funds for “structural reform”. The money for structural reform increase quite fast although no structural reform is being done. It seems that is a way for additional spending by the ministries. This additional spending is not justified, because the expenditures of the government institutions are too large and inefficient anyway.

H. Interest expenditures

The fiscal reserve and the proceeds from a faster privatization can be used for capitalization of the pension system and/or for payoff of the government debt (that will reduce the interest payments).

Table 3: Expenditures of the alternative government budget, prepared by IME

	2004		2005 - government		2005 - IME	
	Mln. levs	% of GDP	Mln. levs	% of GDP	Mln. levs	% of GDP
Total expenditures	14 645.9	38.6	16 262.6	39.3	13 757.7	32.8
1. Non-interest expenditures	13 857.7	36.5	15 447.1	37.4	13 242.1	31.6
<i>Current non-interest expenditures</i>	12 303.7	32.4	13 402.6	32.4	11 678.9	27.9
Salaries and social security taxes	2230.9	5.9	2399.0	5.8	1962.0	4.7
Maintenance	2 299.9	6.1	2 613.2	6.3	2 299.9	5.5
Defense and security	1 527.1	4.0	1 632.2	3.9	1 232.2	2.9
Subsidies	683.2	1.8	746.5	1.8	373.3	0.9
Social expenditures	5 562.8	14.6	6 011.7	14.5	5 761.7	13.8
- Pensions	3 375.9	8.9	3 668.1	8.9	3 668.1	8.8
- social benefits, compensations	1 167.2	3.1	1 219.6	2.9	1 019.6	2.4
- healthcare fund	769.7	2.0	863.6	2.1	813.6	1.9
- other	249.9	0.7	260.4	0.6	260.4	0.6
<i>Credits and temporary aid</i>			100.0	0.2	-	-
<i>Capital expenditures</i>	1 330.2	3.5	1 594.9	3.9	1 463.2	3.5
<i>Reserve</i>	223.7	0.6	349.6	0.8	100.0	0.2
2. Interest expenditures	788.2	2.1	815.6	2.0	515.6	1.2
Surplus/deficit (+/-)	-	-	-195.60	-0.5%	728.30	1.7%

4. Increase of wages because of the tax cuts

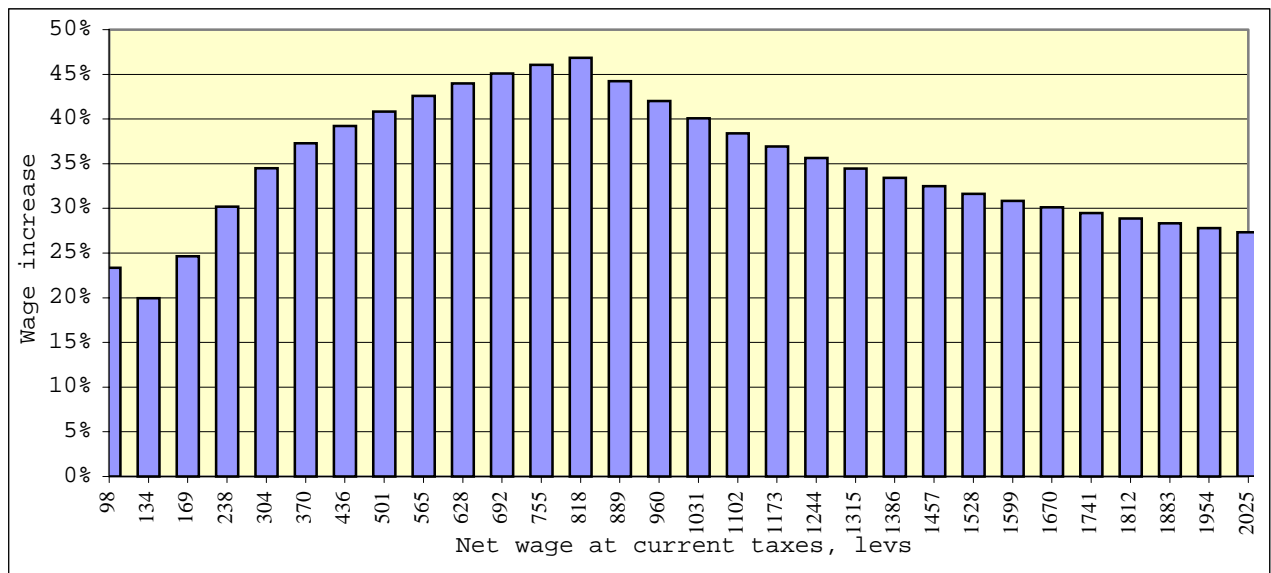
The current taxation system taxes the labor costs of the employers with social security tax, then the gross wage is also taxed with social security tax and the remaining money are taxed with income tax. The total rate of the social security tax is 42.7% of the gross wage, and the income tax in 2004 is between 12 and 29% (according to the amount of income).

As mentioned above, we propose tax cut, which will lower the social security tax rate to 10% and the income tax rate to 10% (therefore the combined tax on labor will be 19%). We expect 70% of the social security tax cut to go to the employee and 30% to the employer.

On figure 1 we can see the increase of the net salaries because of the introduction of 10% tax rates. The average increase of the net salaries is 30%; the people with lowest and highest incomes will get about 25% increase of the net wage; the so-called middle class will receive about 35-45% increase of the net wage. The reason is that at the moment the middle class pays the highest tax rates.

The net monthly income of an average family (with two working people) is about 470 leva after taxes. As a result of the social security and income tax cut to 10%, the net income of this family will reach more than 600 leva. The annual increase of the net income of the family will be 1700 leva.

Figure 1: Increase of salaries because of the 10% tax rates



5. Alternative budget: 3-year budget reform

Because of the forthcoming membership of Bulgaria in the European Union in 2007 and because of the need for further reduction of the tax burden and reforms in the budget expenditure, we propose the following reforms for 2006-2007:

In 2006

- Healthcare reform – private competitive health funds, privatization of the state health fund and hospitals
- Pension reform – 8% of the gross salary go to a private pension fund (instead of the state pension fund)

- Voucher system in the education
- Continuing reduction of the public service staff
- Continuing reduction of the subsidies for loss-making activities
- Budget revenues – 29.9% of GDP, expenditures – 28.1% of GDP

In 2007

- Zero corporate tax (elimination of the taxation of profits)
- Program budgeting
- Adjustment of the excise tax rates according to the EU minimal requirements

- Continuing reduction of the public service staff
- Continuing reduction of the subsidies for loss-making activities – EU starts to subsidize Bulgarian agriculture, the Bulgarian subsidies are entirely removed
- Budget revenues – 28% of GDP, expenditures – 26.2% of GDP

The proposed reforms will ensure a stable double-digit economic growth and corresponding rapid increase of the incomes of Bulgarian citizens. In addition, the reforms will increase the efficiency of the public spending and the quality of the public services, healthcare and education.

Table 4: Alternative government budget, 2005-2007

	2005		2006		2007	
	Mln. leva	% of GDP	Mln. leva	% of GDP	Mln. leva	% of GDP
Total Revenues	14 436.2	34.5	14 047.0	29.9	14 828.1	28.0
1. Tax Revenues	11 272.2	26.9	10 853.2	23.1	11 554.3	21.8
<i>Direct taxes</i>	3 798.3	9.1	2 438.4	5.2	1 981.4	3.7
Corporate taxes	917.4	2.2	1 027.5	2.2	387.0	0.7
Income tax	1 259.8	3.0	1 410.9	3.0	1 594.4	3.0
Social security tax	1 621.1	3.9	-	-	-	-
<i>Indirect taxes</i>	7 105.0	17.0	8 034.7	17.1	9 172.9	17.3
VAT	4 426.9	10.6	4 958.1	10.6	5 602.7	10.6
Excises	2 344.1	5.6	2 742.6	5.8	3 236.3	6.1
Customs duties	334.0	0.8	334.0	0.7	334.0	0.6
<i>Other taxes</i>	369.0	0.9	380.0	0.8	400.0	0.8
2. Non-tax revenues	2 643.8	6.3	2 643.8	5.6	2 643.8	5.0
3. Aid	520.1	1.2	550.0	1.2	630.0	1.2
Total expenditures	13 707.9	32.7	13 204.3	28.1	13 908.0	26.2
1. Non-interest expenditures	13 192.3	31.5	12 788.7	27.3	13 508.0	25.5
<i>Current non-interest expenditures</i>	11 629.1	27.8	11 137.6	23.7	11 756.1	22.2
Salaries and social security taxes	1 962.0	4.7	1 962.0	4.2	2 089.5	3.9
Maintenance	2 299.9	5.5	2 437.9	5.2	2 596.4	4.9
Defense and security	1 232.2	2.9	1 306.1	2.8	1 391.0	2.6
Subsidies	373.3	0.9	186.6	0.4	93.3	0.2
Social expenditures	5 761.7	13.8	5 245.0	11.2	5 585.9	10.5
- Pensions	3 668.1	8.8	3 888.2	8.3	4 140.9	7.8
- social benefits, compensations	1 019.6	2.4	1 080.8	2.3	1 151.0	2.2
- healthcare fund	813.6	1.9	-	-	-	-
- other	260.4	0.6	276.0	0.6	294.0	0.6
<i>Credits and temporary aid</i>	-	-	-	-	-	-
<i>Capital expenditures</i>	1 463.2	3.5	1 551.0	3.3	1 651.8	3.1
<i>Reserve</i>	100.0	0.2	100.0	0.2	100.0	0.2
2. Interest expenditures	515.6	1.2	415.6	0.9	400.0	0.8
Surplus/deficit (+/-)	728.3	1.7	842.7	1.8	920.2	1.7

20 arguments against minimum wage

Dimitar Chobanov

During the last two weeks, negotiations have been held between the Bulgarian government and the mission of the International Monetary Fund (IMF) concerning the increasing of the minimum wage in 2005 from 120 to 150 leva (from EUR 61.4 to 76.7). Purposed at this are 20 arguments prepared by the Ministry for Labor and Social Policy (MLSP) experts who support that demand¹. Here, an alternative position against minimum wage is presented trying to follow the same order as it is in the original document.

1. Currently, minimum wage level is too high because it should be abolished. The presence of such a minimum impedes the free labor negotiations between the employer and employee. When such restrictions exist this distorts the information transmitted through labor price as these information signals for prices under the minimum cannot be transmitted to the business and to reflect the demand for and supply of labor.
2. If minimum wage is abolished Bulgaria would enter the European Union with more flexible labor market because minimum wage is an impediment to its free functioning.
3. Minimum wage is the only tool of the Ministry for Labor and Social Policy to affect the labor market and its abolishment would deprive it of discretionary power. There is a great number and kinds of programs for people with low or zero income which are sufficient tool for influence.
4. Minimum wage should not be used for social purposes. When an employer hires a worker he compares the marginal cost with the marginal revenue of it. The social meaning of this is that he/she could hire the worker and enable him to generate income but above some level it would not happen. Then, government should provide the entire size of the social minimum instead of giving some sort of additional payment in order to assure it.
5. Minimum wage and its growth create a higher risk of unemployment because when the marginal costs per worker rises and the marginal revenues are constant or fall then the employer will simply hire fewer workers and thus the employment will be smaller than the case when there are not such wage restrictions.
6. Price of labor in Bulgaria is low and it is one of its few competitive advantages. When wages rise faster than the labor productivity, competitiveness is reduced leading to less foreign investment fewer jobs and lower living standards.
7. That is why the only reasonable thing is to link wage and labor productivity i.e. when labor productivity does not rise then minimum wage does not rise either.
8. Share of workers receiving minimum wage in the public sector is small but its increase would cause additional budget costs. This money is taken from the private sector where they could be used more efficiently and to add more value. Hence, the loss for the society would be greater.
9. An minimum wage increase of 30 leva leads to 40 leva increase in employer's costs i.e. there is a negative multiplication effect from it.
10. Lower labor costs are one of the main factors in attracting investors because the infrastructure, property rights, regulations, relations with administration and the other indicators that influence the size of investment have rather negative effect.
11. Bulgaria is competing with all other countries to attract investment because the degree of international integration is rising. Therefore, the conditions for making business among which is the minimum wage and its size should be compared not only with these in the EU but also in any other country.
12. higher minimum wage would cost to the state budget "only 20 million leva" but the private sector costs would be much higher. Analyzing such a measure, we should take into account the whole effect of it not only its impact on the state budget. this effect includes cost-benefit analysis of adoption or amendment of particular regulation which can convincingly prove that the total

¹ The arguments are available in Bulgarian on the website of the ministry:
<http://www.mlsp.government.bg/bg/news/news.asp?newsid=6846&catid=1>

benefits for workers, businesses and budget would exceed the costs. However, such measure would distort in greater extent the negotiation process between worker and employer would contribute for increased total loss for the society reflected in lower employment and fewer goods and services produced and hence lower income and living standards especially for low wage workers who would have to be advantaged of such activities.

13. Following the above arguments, more funds would be taken from the real economy, which, in turn, would probably lead to loss of productive jobs. Of course, government could try to offset this loss by creating more inefficient public sector jobs.
14. According to the MLSP estimates, these funds would equal 68 million leva which is not a small sum having in mind that these costs arise from an amendment of only one regulation. This money is burden not only to business but also to workers who, ultimately, pay the bill. However, related to the joining of Bulgaria to the EU amendments in existing or adoption of new regulations is imposed that additionally increase the burden on the business. In such case, economically unjustified change in regulations not related to the EU becomes even more harmful resulted in an accumulation of requirements that are harder and more expensive to fulfill.
15. Higher minimum wage would not solve the spare jobs problem because if employers assessed that they could pay for a particular job less than 150 leva they cannot change their assessment because of the amendment in a government regulation. This job would not be occupied but just removed but this is

not a way to solve the problem and, in fact, it creates even graver one.

16. Higher minimum wage would contribute to larger size of shadow economy as some workers and employers would rather prefer to continue their relations with wage smaller than the minimum and this largely concerns the wages between 120 and 150 leva.
17. Minimum wage is harmful for low productivity workers, for young people who wish to start working, for some disabled persons and, in fact, for the most vulnerable social groups. Such persons would be hired hardly and it becomes even harder with the higher minimum wage size. Thus, they cannot become experienced or achieve skills, which can be useful to increase their productivity and be more competitive on the labor market.
18. Minimum assurance thresholds to a great extent have the same effect to the minimum wage as in many companies they are used as a compensation minimum and this is another reason for the minimum wage abolishment.
19. The change in minimum wage would not affect positively employees with higher wage than 150 leva but, on the contrary, it is possible when cost for low productivity workers rises the number of high wage jobs to decrease.
20. Workers with wage of 150 leva would receive the minimum and this can discourage them because the evaluation of their efforts would seem relatively lower.

As a conclusion we can say that the only reasonable decision for the minimum wage is to be entirely abolished because of the significant negative effects that it causes on the whole economy and especially on the labor market.

How much does a square meter in Bulgaria worth?

Svetla Kostadinova

Real estate hysteria in Bulgaria makes us wonder what their real price is. Everyone knows that this is the transaction price – when buyer and seller reach agreement and expect benefits from the deal.

What are available sources of such information in Bulgaria?

REMI Index – it is maintained by the National Property Association in Bulgaria (voluntary association of real estate brokers). The major problem with this index is that the data is supplied on voluntary basis, the index is released quarterly and it is too general (no details on type, age, infrastructure, properties of the real estate).

Despite this, the REMI index is still one of the good initiatives.

Real estates Internet sites – several sites supply information on real estate prices but this is the asking price that can be misleading and cannot be used for in-depth analysis. This however can be the closest to market price that is available for the public at the moment.

National Statistics Institute (NSI) - the prices quoted by this institute are much below the market. The main reason is that the notaries (major suppliers of data for NSI) possess underreported data on real estate transactions because participants avoid paying taxes.

Real estate brokers – they possess all the information about property prices but are unwilling to provide it because it is considered as main competitive advantage.

Who are the main users?

Buyers/Sellers – they will benefit from this information the most because in this case they will be able to avoid speculations. Making such information publicly available will accelerate and facilitate market transactions.

Banks, insurance companies, pension companies, etc. – at the moment they hire licensed appraisers to determine the RE market price. These appraisers in turn rely on RE brokers. In all cases the database that is compiled within one company is limited and does not represent the market as a whole.

Real estate appraisers themselves – they use different methods to determine the property price and whatever they choose they always consult with real estate agencies (usually they have contract for exchange of information for a price).

Analyzers and journalists – they monitor and analyze the market and try to forecast future developments. Therefore, they need reliable and up-to-date information.

Local and foreign investors – they rely on such data so to assess future result of their investments. Since 2002, the Bulgarian real estate market is experiencing huge interest from abroad and availability of historic information is crucial for predicting future developments.

Why then there is no such index in Bulgaria?

The main reason is that participants in real estate market do not trust each other and hide

information on parameters of the deals. Many of the active brokers are not properly licensed and operate semi-legally and therefore will use this information “for free”(without having obligation to provide such data).

Another reason is the current property market situation – “the dominance of the seller”. Buyers do have expectations for continuing rising of prices in future and are ready to pay almost any price without bargaining. Among the winners from current situation are brokers and construction companies. Since they are among the main suppliers of this information and as long as they do not reach an agreement on conditions, the index cannot become real. Bearing in mind the size and features of RE market, an effective mechanism that will alarm market participants for upcoming negative development should be put in place.

What can be done?

We present two options below.

1. Real estate market participants join forces, supply data, organize and produce real estate index. This can be done if most brokers commit themselves to supply regularly data. Certain methodology should be prepared so the authenticity, security and reliability of information be guaranteed for all suppliers; each participant can receive information only of he has provided such before; the model can allow for preparing of inquiries by different parameters – size, type of construction, year, etc. for each property. The maintenance of such index can be secured with introducing of fees for receiving data and selling of aggregate market analysis.

Since most of real estate agencies are not willing to cooperate and join hands to make such index (at least at the moment) there is another option that is not the best solution but can accelerate the process and facilitate establishment of property market indicator.

2. Banks and non-banking financial institutions are one of the most important participants and users of such index. The accumulated funds within them that are strongly correlated with real estate market development are a good reason to get involved in RE index establishment (or any sub-real estate index).

Mortgage financing in Bulgaria is growing rapidly – interest rates are falling, borrowers requirements are eased, maturity is increasing and all this makes creation of similar index of

vital importance for future developments in mortgage market.

A good idea is to create one single “internal” database ¹ by all banks and/or non-bank financial institutions (or at least most of them) for all properties that have been mortgaged, insured, securitized or acquired as investment. Thus, a good database will be accumulated and creation and maintenance of real estate index can be facilitated in the future.

Why is this easier to come true?

First, banks are easier to be organized – they proved that by participating in the first private credit bureau establishment that will start operation very soon. The information that should be delivered is easy to be extracted from bank’s databases.

Second, banks have the technical equipment for maintaining, supplying and organizing such information. Financial institutions can easily assign one person to perform administration

functions in respect to such database. Most brokers are very small companies that often do operate semi-legally and do not have elementary equipment.

Third, financial institutions often decide on such issues more easily than other companies – they can assess objectively the benefits of such system.

Forth, financial risk is greater in a market where reliable information does not exist.

Finally, “intelligence” of property prices by banks requires constant monitoring, funds and a certain degree of uncertainty.

Of course, creation of one single index with RE agencies and brokers is always the best solution.

¹ The Polish Banking Association is the initiator, organiser and administrator of similar database (Transaction cost database). The database is expected to be active soon.

Study of Incentives, Characteristics and Strategies of Firms Operating ‘in the Shadows’

Martin Dimitrov

IME conducted a survey of firms’ strategies and incentives to engage in informal activities and the resulting characteristics of company organization and strategy. The report is available at - [link](#). By ‘informal’ economy we mean all the voluntary exchanges of labour, goods and services, which take place undetected by the government. IME and GfK in Bulgaria, Romania and Serbia and Montenegro did the field data collection via sociological survey (60 firms per country).

Only part of individual’s economic life may be in the informal sector. In all cases he or she faces the general (optimisation) problem, which involves the choice between registered and informal economy. The government detection of a deal does not change the matter and essence of the deal itself. However the choice between formal and informal has implications on the *costs of the transaction*. Other thing equal, the

parties will choose the form of transaction that implies the lowest transaction costs.

Certain economic regulations create significant disincentives to operate formally. As a result, some entrepreneurial ideas never reach the marketplace, some start informally, some are performed by otherwise formal company but without permission to engage in the particular activity, some are not complying with taxes and/or other liabilities to state.

It is often the case that long-term strategies and market behaviour change when environment is one with proliferating informal activities. The individual entrepreneur adjusts his/her own intentions to a situation in which his/her competitors pay no (or less) taxes, and when in most cases contracts are informal and can hardly be enforced by courts.

Summary of findings on incentives:

- There is a widespread perception that the informal economy is large and that it is an exogenous factor. If the share of the informal economy is substantial, then it takes somehow part in the formation of each player’s strategy. Thus it contributes to shaping the incentives that

direct the effort of almost any active person and form the business strategy of any enterprise;

- Tax burden appears as the most significant factor conducive to informality; but the overall administrative burden appears to be much higher than its visible part such as taxation;
- Evasion of labour tax is the most widespread form of tax evasion;
- The rise in the tax burden diminishes incentives to engage in productive activity;
- The incentives to engage in protective (rather than productive activity) must be attributed to both the seller and the buyer of labour. Thus the motivation for informality must be ascribed to a much wider population than just the business community;
- Informal activities are one of the strategies firms choose to reduce transaction costs; the state contract enforcement mechanisms are considered unreliable by majority of firms;
- There are major implications from operating informally on the manager- labour relationship, on competitiveness and company growth;

The overview of the study findings, as well as numerous other studies of the topic allows us to summarize the following common business strategies for SEE:

- In an environment of overwhelming informality firms trade with known partners and do not recourse to official contract enforcement institutions;
- Vertical integration emerge as a mean to reduce the cost of transacting;
- Owners usually dominate company structures and impose informal intra-organizational labor relations, thus preventing the utilization of the competitive and formal market for specialized labor;
- In certain activities (non-specialized labor, mass commodities, etc.) staying informal and avoiding taxes is the dominant competitive strategy to reduce costs, and therefore – selling price; thus informality in these sectors is mutually-generating;
- In markets of direct, simple and self-enforcing transactions (they prevail on the Balkans as shown by various studies of post-communist transition) a firm can grow in the

shadow sector without facing the opportunity cost of lacking access to formal institutions;

- The majority of the unreported activity takes place in the form of partial-informality, i.e. the businesses comply at least with some of the regulations, pay some of the taxes due, register their labour contracts, etc;

Policy Recommendations

Above findings could be addressed through - first of all - national policy mixes. The tacit mission of our project, however, is to recommend policy measures that might be applied in the context of EU integration (accession, regional cooperation and stabilization and accession process).

The recommendations below attempt to distinguish national and EU policies. Depending on the context, the problem could stem from the fact there is inefficient EU approach to challenges in different areas.

1) Tax and quasi-tax, including administrative, burdens should be lowered and simplified. Due to the relative ease with which economic agents can cross over to the unofficial economy and the high tax, quasi tax and administrative burden, it appears that SEE countries fall into the negative sloping segment of the Laffer curve – that is higher tax rates may be resulting in lower tax revenues. On the contrary, more moderate and lower tax rates may result in a significant increase in the tax base. Tax-“harmonization” comments and “requirements” referring to lower direct taxation in new (2004) members-states do not take into account above impacts and do not seem justified.

- Regarding taxes, the policy that helps eliminating incentives to informality is reduction and simplification of direct taxes, including mandatory social welfare contributions. It should include, besides tax cuts, unification of national treatment, elimination of special exemptions and preferences. Surveyed countries follow the overall 2004-accession pattern to lower and make flatter direct taxes.

- Regarding quasi-taxes (i.e. costs of dealing with the government, compliance costs and administrative entry barriers) there are principle policies related to facilitation of entry and business registration, separation of inspections/controls from commencing activities, reduction of licences and permits, depersonalisation of thus reformed

administrative process – use of one stop shops and e-government.

2) Transposition of the *acquis* and the stabilization and association process (SAP) result in new legislation and regulations. They should take into account the preparedness of local businesses and citizenry to comply and the capacity of national administrations to enforce new rules. This and other studies show that a significant incentive for informal economic activities are regulations that are too restrictive or costly, and at the same time, not uniformly applied to all businesses.

- A step in this direction is the introduction of systematic Regulation Impact Analysis (RIA), be it in the form of cost efficiency and/or cost benefit analysis. The processes of both economic transition and EU accession involve adoption and implementation of an enormous amount of new legislation and regulations. An important option is the introduction (institutionalisation within a separate unit or within a ministry) of a RIA Unit for systematic preliminary assessments ensuring large public participation (compulsory consultation procedures) and public scrutiny (publication on Internet, other media).

EU does not have a unified approach to this challenge; the member states vary in their accountability and government-in-the-sunshine experience. Accession countries, with a relative success, apply some version of RIA in an attempt to keep costs under control. Similar policies of future members (Bulgaria and Romania, and SAP countries) must be welcome and encouraged.

3) Economic openness. State policies should target openness including free movement of goods, services, capital, people and improving accountability of procedures (e.g. public procurement) as a precondition for lengthening production processes and increasing value added instead of imposing protectionist measures. Integration in international value-added chains and corporate structures leads to formalization of business activity. Therefore, national policies should allow for free penetration and cooperation of capital in a larger economic

space, thus providing opportunities for businesses to expand. Economic openness embraces liberalization.

- The argument favouring radical versus gradual/partial economic liberalization is even stronger in settings like SEE with a large unofficial economy. The liberalization effort has to be sufficiently substantial so as to lower expected official costs of doing business to a level below those of operating unofficially.

4) Accountable provision and financing of public services. This may include two policy options: a) introduction of program-oriented budgeting in public spending and b) decentralization of spending and taxing decisions, i.e. fiscal decentralization.

- The present prevalence of centralized and historic-based public finance is both non-transparent and not focused on providing public services used and demanded by most of the business community. Taxes, quasi-taxes and all other fees paid by citizens should therefore be closely related to specific public services in transparent and accountable manner.

- Decentralization, understood as accountability of those who collect and spend taxes, will increase the decision-making powers of individual business people who will then be able to decide how much to pay through taxes and fees and how to direct the public funds to serve their interest in the best manner.

5) Governments should put more emphasis on improving enforcement of existing regulations rather than increasing the number of laws and regulations to be enforced.

- At the same time, there is a natural tendency for bureaucrats to expand their agencies in both authority and resources. Therefore governments should specifically address this problem and restrict proliferation of administrative units and regulations. Otherwise, the above-mentioned process of over-regulation leads to hypertrophy of laws and erosion of the rule of law curable through codification, deregulation and simplification.

**Minister of Finance: In Defence of
Libertarianism and Zero Tax Rate**

**Academic address of Minister Milen Veltchev
on “*The Inequality of Freedom, and the Lack
of Liberty in Equity*”**

Mr. President,

Dear Lecturers and Students,

Ladies and Gentlemen,

Please, allow me to express my gratitude to you all for the high honour of conferring on me today the title of Doctor Honoris Causa of the University of National and World Economy. I would like to thank sincerely the Academic Council of UNWE for the attention shown to one of their alumnus – proud, happy and sincerely moved by the opportunity to receive the most precious recognition for his work and achievements by his own university. Please, allow me to share with you that this moment is even happier for me also due to the fact that the title conferred on me is also recognition for the work of all adherents, colleagues, professionals without whom the achievements that have attracted your attention would not have been possible. And let me add that this high honour I owe to any one of us, who have contributed the successes of our country to become visible, the achievements real and the progress – material.

Today I would like to defend before you an idea that inspires me, an idea in which I believe; a modern and at the same time old philosophy about freedom, about the building of a free civil society of economic progress and prosperity, a society which our country is aiming at. I am speaking about libertarianism.

In a sense, there have always been only two key concepts in all political philosophies: liberty and power. The first acknowledges the right of the individual to govern his own destiny by following his views, beliefs, attitudes and desires, providing he respects the same rights of the others. The second, figuratively said, “exports” and imposes its own idea about good and right, not recognizing the right of the individual to err even towards himself, but most of all towards the right direction drawn by the power. Of course, it is no surprise, that the philosophy of power has usually been more attractive for those, who are in the power.

The philosophy of freedom has had many names. It can be found in ancient Eastern thought; it provoked the minds of the Greek civilization; it is defended by Christianity. The philosophy of freedom changes its faces, its names, its heralds down the ages in order to reach us in its constant nature – respect for the individual and confidence in the ability of ordinary people to make wise decisions about their own lives.

Libertarianism, as the name itself suggests, is belief in that every person owns his own life and property and has the right to choose what to do with them as long as he respects the same right with regard to others. Hence, it is evident that libertarians consider the individual to be the main unit of social analysis – it is the individuals that make the decisions, but it is also them who “own up” to their acts, that is, that they take responsibility for what they do. Since the individuals are moral subjects they have the right to be protected in their lives, freedom and property. And these rights are not a gift from the state or society, but on the contrary, they are inherent to the nature of human beings. It is no chance that one of the most famous books of all times which has played an enormous role for the development of Western civilization – The Social Contract by Jean Jacques Rousseau begins with the following proclamation: “Man is born free; and everywhere he is in chains”. This concept preordains the position of libertarian philosophy with regard to the state, namely that its role should be brought to that of a protector of the primary human rights, where they may be violated, but that should be done with minimum intervention in the life of the individual in order not to infringe upon his right to autonomy. The right to precisely that freedom, where the individual is unrestricted in his creative and productive impulses, the freedom whereby the individual is strong to interact with others, to make a choice, to err and to bear the consequences of his errors, but mainly to create goods, a future and a better life for himself and as logical result – for the society.

Where in the broad political spectrum is the place of libertarianism – whether next to the left idea of the social state or closer to the market concept of the right wing? Some say that libertarianism is neither left nor right if we go by the definitions of contemporary politics. Others think that it combines in an appropriate manner the best in the two antipodes, to step, on the one hand, on the left position of self-government as

tolerance towards the others, and on the other, on the right one – of responsible economic behaviour. And the combination of these two bases leads to social harmony and material prosperity. Third paraphrase this concept and, by way of a joke, maintain that libertarians are right in economic matters and left – in the social ones.

Today I am not addressing you to electioneer for the ruling coalition NMSS – MRF. I think though that the sharply cut down tax rates during the past years speak of more than just a linguistic coincidence between libertarianism and the liberal character of our two political parties.

Libertarianism, however, is not only a political philosophy. It is an idea, conception, intuition, what liberty is in itself, therefore it is fight for the right of free choice and tolerance in all spheres of our lives. We will find the libertarian idea in the efforts to establish religious tolerance, in the abolitionist movement in the USA, in the fight for non-discrimination of various groups of people.

I hope that you will forgive me for being pragmatic as a man of finance, Ladies and Gentlemen, which makes me choose only one of these spheres and just talk about some of the basic economic views of libertarianism. In order to get ourselves near to the economic vision of the philosophy of freedom, I would like to share with you two fundamental principles which undoubtedly are the primary characteristics and engines of free economy. They are simple, evident and irrefutable. Let us start with the first one that can be presented as follows:

“Free people are not equal and equal people are not free.”

I am quick to clarify which equality I actually mean. Of course I do not mean equality before the law or political liberty; it is not about politically free people who are not equal before the law. „He who confuses political liberty with freedom and political equality with similarity has never thought for five minutes about either”, G.B. Shaw said on a similar occasion.

What it is actually all about is economic equality – income and economic status, in other words all we can offer and acquire on the free market.

In order to better explain this principle, let us divide it into two and start with “Free people are not equal”. I suppose you will agree that when people are free to be themselves, to command

their fortune, to freely make efforts to improve their well-being and that of their families, the market outcome could not be equal income for everyone. Since indisputably everyone of us is a unique human being, different from any other that has ever existed, why should we expect that our actions and market interrelations would yield equal results? We all have different gifts, talents, skills. Some of us have more or more highly esteemed gifts than others have. Sometimes we find our true vocation not until a later stage of our lives. What is important is to be free to seek for it.

We are also different in the extent of our entrepreneurship, in our preparedness to work, in our efforts we devote to it, we are also different in our ability to save. I would bet that if someone managed to make us all equal in income and prosperity overnight by just clicking their fingers, this time tomorrow we would all be different again for some of us would have saved part of their money while others would have spent it all.

All this makes us conclude quite logically that if people are free to be themselves, they could not be economically equal.

That is why, I cannot agree with the proposition that transition in Bulgaria will end only after everybody will have become rich and started living like the average European. There is no average European. This concept groundlessly conceals the huge abyss between the poor unemployed and homeless people and the inconceivably wealthy aristocrats of an England, for instance. We do not state that since 30% of Americans do not have health insurance, the USA have not yet come out of transition, do we?

As far as the second part of this principle is concerned, namely that “equal people are not free”, I would suggest thinking together for a moment and trying to find a country where people are really economically equal. If you have already managed to think about such a country, let me convince you that people in that country are not free at all. Why? Frankly speaking, the only way to make the income and well-being equal in a given society is to suppress the capabilities of the more enterprising ones; to impede their self-development and becoming well-off, to artificially retain minority's development, for, alas, highly gifted people are always a minority, so that we can make their speed equal to that of the slower, less active majority. In other words, the only way is to

literally use power to make the talented ones obey orders like: Do not do well! Do not work more and better than the others! Do not serve better than your competitors! Do not save and do not spend more reasonably than the others! I hope that none of us would like to live in such a society especially after the unlucky attempts of the communist regime to unify us all by frequently using similar methods of power.

Let me give another example from the international tax practice. Without going into the specifics of the tax laws, which have just been voted by the Bulgarian Parliament, I would like to note that the libertarian idea of non-intervention of state and of free market relations envisages low tax rates that are to promote production and business. Of course, we should not forget that what our government is also striving at is a smooth phased process. What I wanted to share with you is concerning the high taxes and in particular – the highly segmented bracket for personal income taxation traditionally proposed by the left political forces. When we raised the salaries in the budget sphere this summer it turned out that many of the employees were not satisfied. And it is quite natural. It was secret for no one that the increased income of many of them passed to the next stage of the tax bracket, which automatically meant higher percent of income tax. That is to say, many people asked themselves the question: “What do I need a higher salary for when my real income grows more slowly?” We know that payment may be increased for various reasons – individual approach of the employer when the employee works well, improvement of qualification, etc. What stimulus would you have to improve the quality of your work or your skills if your payment would not actually increase? Shouldn't people strive to work more and better in order to increase their wealth? And should they be sanctioned in this striving of theirs? Should we aim at relatively standardizing people in their payment regardless of the different efforts, time and skills they commit to their work. The tax legislation in countries like the United Kingdom, the Netherlands and Ireland where the personal income tax bracket has not more than 3 stages affirms this conclusion.

Now I would like to avail of the opportunity to express a position that in the next days may be considered brave by the well-wishers and reckless – by the ill-wishers.

It is a challenge for me to be the first Finance Minister who supports the recent appeal of Prof. Victoria Curzon Price, President of the Mont Pelerin Society, to globally abolish the corporate income tax.

I have mentioned above that I would dwell on two basic principles of the economic philosophy of libertarianism. So far, I have dwelled on the principle of free inequality and lack of liberty in equity. And the other principle is:

“People take care of what is their own. What belongs in common to the most people is accorded the least care: they take thought for their own things above all, and less about things common.”

This principle underlies the “magic effect” of private property. It also gives a key explanation of the failure of socialist economies in the world.

In the Soviet Union, and in Bulgaria before 1989, the authorities proclaimed supremacy of central planning and public property. They believed that private property was selfish and non-productive and tried to convince us that under the competent management of the central government the resources would be used for the general welfare. The food of the farmer became “food of the people” and people were hungry. The factory of the entrepreneur became “factory of the people” and started manufacturing goods that could not be sold in any foreign market.

And if you believe that you can equally well take care of any property I would advise you to go and live in the house of someone else and drive his car for a month. I guarantee that neither the house, nor the car would look in the same way as your own do after the same period of time.

That is why the concept that people are more assiduous and use the resources more wisely if the ownership over the property is private is a working one.

Another benefit of the private property, which is not so much economically obvious, is that it allocates power. When a subject like the state owns the whole property individuals have no protection against its will. The institution of the private property allows many people to find their own place where to be protected from the hostile actions of either other people or the state.

Ladies and Gentlemen,

Liberal and libertarian concepts actually have their long tradition in Bulgaria, too. Immediately after the liberation of our country in 1878 many of the builders of the Third Bulgarian State adopted this philosophy and this approach to the government of society, economy and state. And it is quite logical – great number of them had been active participants in the national liberation struggles. In their view the concept that each person has an inherent right to existence, freedom and property was a natural continuation of their ambitions and dreams to see their mother land an independent and prosperous state.

Today, after a long and difficult period of isolation and totalitarianism, after another equally difficult and long period of transition, a significant part of the Bulgarian society sees again in these ideas a chance for a more successful and accelerated development of the country. Development which is based on

transparency in politics, on private property, low taxes, free markets and competition in economy, on decentralization of power, on people's free choice. Because freedom is no luxury. It is much more than a lucky coincidence or a concept we defend by sheer force of habit. Freedom is the driving force behind everything that happens in us, with us and through us. Let's live in this freedom to be ourselves and to remain tolerant to others. Or as Doctor Kenneth Bisson, member of the American Libertarian Party, jokes: "Libertarianism is what your mom taught you: behave yourself and don't hit your sister".

Ladies and Gentlemen,

I am glad I had the opportunity to share these ideas with you today and I would once again like to thank you for the high honour you bestowed on me.

Thank you for your attention

We Present

[European Union Savings Directive: Effect on Bulgaria](#)

http://www.ime.bg/pdf_docs/papers/EUSavings.pdf

We Recommend

[Contemporary Economic Libertarianism in Bulgaria](#)

Materials prepared by the Institute for Market Economy for the *First European Resource Bank - Promoting a free and responsible Europe*, Borovets, Bulgaria, October 29-30, 2004

http://www.ime.bg/en/Europe_Bank_Eng.htm

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